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No. 91-1421

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1992

UNITED STATES OF AMERICA,
Petitioner,

v.

WILLIAM F. HILL and LOLA E. HILL,
Respondents.

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FEDERAL CIRCUIT

BRIEF FOR THE RESPONDENTS

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(i)

QUESTION PRESENTED

Whether the unrecovered cost of depreciable (tangible) improvements to an oil and gas property may properly be included in the adjusted basis of the property (as defined in section 614), for purposes of determining the amount of the depletion deduction that constitutes a tax preference item subject to the minimum tax under section 57(a)(8) of the Internal Revenue Code.

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BRIEF FOR THE RESPONDENTS

STATUTES AND REGULATIONS INVOLVED

1. Section 57 of the Internal Revenue Code,¹ 26 U.S.C.
57 provides in relevant part:

(a) *In General.* — For purposes of this part, the
items of tax preference are —

(8) *Depletion.* — With respect to each property
(as defined in section 614), the excess of the deduc-

¹All references to "IRC", "Code", "Internal Revenue Code" or "section" in this Brief mean Title 26, U.S.C., the Internal Revenue Code of 1954, as amended to the tax years at issue.

tion for depletion allowable under section 611 for the taxable year over the *adjusted basis* of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year). (Emphasis added).

2. Section 1.57-1(h)(3) of the Treasury Regulations,² 26 C.F.R. 1.57-1(h)(3):

(3) *Adjusted Basis.* For the determination of the adjusted basis of the property at the end of the taxable year *see section 1016 and the regulations thereunder.* (Emphasis added).

3. Section 1.1016-1 of the Treasury Regulations, 26 C.F.R. 1.1016-1 provides in relevant part:

Section 1016 and §§1.1016-2 to 1.1016-10, inclusive, contain the rules relating to the adjustments to be made to basis of the property to determine the adjusted basis as defined in Section 1011.

4. Section 1.1016-2(a) of the Treasury Regulations, 26 C.F.R. 1.1016-2(a):

(a) The cost or other basis shall be properly adjusted for any expenditure, receipt, loss, or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property.* No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year. For example, in the case of oil and gas wells no adjustment may be made in respect of any intangible drilling and development expense

² All references to "Treasury Regulations", "Treas. Regs.", or "Regulations", mean the Treasury Regulations in effect for the tax years at issue, 26 C.F.R.

allowable as a deduction in computing net or taxable income. *See the regulations under section 263(c).* (Emphasis added).

STATEMENT

1. During 1981 and 1982, Respondents (hereinafter referred to as "Taxpayers") were engaged in the business of oil and gas exploration, development and production. (Pet. App. 3a)³ Taxpayers claimed depletion deductions of \$439,884 for 1981, and \$371,636 for 1982, on their federal income tax returns, with respect to their oil and gas properties. (Pet. App. 4a). Taxpayers paid a minimum tax of \$29,812 for 1981 and \$26,736 for 1982 with respect to the portion of their depletion deductions that constituted a tax preference item under Code section 57(a)(8). (A. 7)⁴ Under Code section 57(a)(8), the amount of depletion that constitutes a tax preference item for the taxable year is the excess of the depletion deduction for that year over the adjusted basis of the property at the end of the year. Taxpayers determined the amount of their tax preference item by including the unrecovered cost of depreciable (tangible) improvements⁵ to their oil and gas properties in the calculation of adjusted basis. (Pet. App. 6a) The Internal Revenue

³ "Pet. App." refers to the Appendix to Petitioner's Petition for a Writ of Certiorari in this case.

⁴ "A" refers to the Joint Appendix filed by Petitioner in accordance with Rules of the Supreme Court of the United States, Rule 26.

⁵ "Depreciable improvements", "tangibles", or "tangible improvements" are the casing, pumps, pipes, well equipment and similar items connected to the mineral deposit for the purpose of developing and operating the property. *See* Treas. Reg. section 1.611-5(b)(4) and Treas. Reg. section 1.612-4(c)(1).

Service ("IRS") disputed Taxpayers' minimum tax calculation and asserted additional taxes owed. (A. 7) Taxpayers paid the resulting deficiencies under protest and filed a refund claim which the IRS denied. Thereafter, Taxpayers filed suit for refund in the Claims Court.

2. On Cross Motions for Summary Judgment, the Claims Court held that Taxpayers were entitled to include the unrecovered costs of the depreciable improvements to their oil and gas properties in the calculation of adjusted basis for purposes of Code section 57(a)(8). The Court of Appeals for the Federal Circuit affirmed, adopting the opinion of the Claims Court.

SUMMARY OF THE ARGUMENT

Ever since enacting the earliest income tax laws, Congress has maintained a policy of encouraging the development of our Nation's natural resources, through tax incentives, such as the percentage depletion deduction. *See Comm'r. v. Engle*, 464 U.S. 206, 208 (1984). In 1969, when Congress established the minimum tax, it intended to reduce the tax benefit derived from various deductions, such as the depletion deduction. However, in drafting Code section 57(a)(8), Congress had to determine how much of the depletion deduction could be subjected to the minimum tax without undermining the important tax incentive provided by the depletion deduction.⁶ The critical focus, when analyzing how Congress resolved this policy dilemma, must be the words

⁶"A significant portion of the Nation's energy policy is located in the Internal Revenue Code, rather than in Federal outlay and regulatory programs." Joint Committee on Taxation, *Present Law and Proposals Relating to Increasing Domestic Energy Production and Reserves*, (JCS 23-90) July 26, 1990.

of the statute and the related regulations. *See Patterson v. Shumate*, 112 S.Ct. 2242, 2248 (1992); *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989).

1. Section 57(a)(8) requires taxpayers to pay a minimum tax for depletion only to the extent that the annual depletion deduction for each mineral property *exceeds the adjusted basis for that property*. Adjusted basis, for these purposes, is determined pursuant to section 1016 and the related regulations. *See* Treas. Reg. section 1.57-1(h)(3). Treas. Reg. section 1.1016-2(a), in turn, provides that the adjusted basis of property *includes the costs of improvements and betterments made to the property*. Petitioner has acknowledged that the tangible improvements at issue here are improvements to Taxpayers' mineral properties. Therefore, the Claims Court and the Court of Appeals correctly held that the unrecovered costs of these improvements should be included in the calculation of adjusted basis for purposes of Code section 57(a)(8).

2. Ignoring the unambiguous language of the Code and the Regulations, Petitioner argues that tangible improvements cannot be included in adjusted basis because of Code section 57(a)(8)'s reference to the definition of property in section 614. Section 614 defines the term "property" to mean each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. Section 614 also provides extensive rules for determining when a taxpayer's separate interests can be combined into a single property. Section 614 does not, however, provide any rules for calculating the adjusted basis of the property. The definition of property under section 614 is only the starting point for calculating adjusted basis. Nothing in section 614, or the related regulations, directs taxpayers to ignore the

provisions of Treas. Reg. section 1.1016-2(a) when calculating adjusted basis under Code section 57(a)(8). Indeed, Treas. Reg. section 1.57-1(h)(3) directs that such rules be followed.

—3. Petitioner's argument mistakenly equates the calculation of adjusted basis under Treas. Reg. section 1.57-1(h)(3), with the calculation of depletable costs under Treas. Reg. sections 1.612-1(a) and (b)(1). Treas. Reg. section 1.57-1(h)(3) directs taxpayers to calculate adjusted basis, for purposes of Code section 57(a)(8), in accordance with the rules of Code section 1016 and the Regulations thereunder. These rules require that the cost of improvements be included in the adjusted basis of property without reference to the cost recovery method used for calculating the tax deductions associated with those improvements. Treas. Reg. sections 1.612-1(a) and (b)(1), on the other hand, direct taxpayers to calculate the depletable costs for a property pursuant to a *special rule* which specifically excludes tangibles from the calculation. The fact that Treas. Reg. sections 1.612-1(a) and (b)(1) prescribe a *special rule* that excludes tangibles from the calculation of adjusted basis, *for the limited purpose of calculating cost depletion*, confirms that for purposes of calculating adjusted basis under the *general rules* in Treas. Reg. section 1.1016-2(a), which apply for purposes of section 57(a)(8), the cost of tangibles is included in the computation.

4. Since the Petitioner cannot find support for its position in the Code and Regulations, it is urging this Court to ignore them and to focus instead on other factors, such as Petitioner's current view of the legislative intent. Petitioner's argument, however, begs the question of legislative intent by presuming a Congressional purpose consistent with its position. If Treasury had

always interpreted legislative intent in a manner consistent with its litigating position in this case, it would have drafted Treas. Reg. section 1.57-1(h)(3) to include a special rule excluding tangibles from the calculation of adjusted basis. See Treas. Reg. sections 1.612-1(a) and (b)(1). As discussed in the preceding paragraph, however, no special rule was included in the section 57 Regulations. To the extent Congressional intent is relevant, Treasury's contemporaneous and long standing interpretation of the statute is a better guide than an interpretation advanced during this litigation.

ARGUMENT

I.

THE UNEQUIVOCAL LANGUAGE OF THE CODE AND REGULATIONS REQUIRES THAT TANGIBLE IMPROVEMENTS MUST BE INCLUDED IN ADJUSTED BASIS FOR PURPOSES OF CODE SECTION 57(a)(8).

A. The Code and Regulations Provide a Formula for Calculating Depletion as a Tax Preference Item Under Code Section 57(a)(8).

Code sections 56 and 57 establish a separate tax regime pursuant to which a minimum tax is imposed on a portion of certain tax deductions otherwise permitted under the Code.⁷ The rules for determining what portion of those deductions constitute tax preference items and, hence, are subject to the minimum tax are set forth in Code section 57.

⁷ During the years involved in this case, the minimum tax was 15% of the amount by which the sum of the taxpayer's "tax preference items", defined in section 57, exceeded certain deductions permitted under section 56.

Code section 57(a)(8) provides the formula for determining how much, if any, of a taxpayer's depletion deduction constitutes a tax preference item. This formula provides that the excess of the depletion claimed during the year with respect to each mineral property over the taxpayer's adjusted basis for that property, constitutes a tax preference item. Code section 57(a)(8) provides as follows:

(a) *In General* — For purposes of this part, the items of tax preference are —

(8) *Depletion* — With respect to each property (as defined in section 614), the excess of the deduction for depletion allowable under section 611 for the taxable year over the adjusted basis of the property at the end of the taxable year (determined without regard to the depletion deduction for the taxable year).

The property whose adjusted basis must be determined is defined by section 614 to mean each *separate interest* owned by the taxpayer in each mineral deposit. Code section 614(a) and Treas. Reg. section 1.614-1(a)(1). The regulations under Code section 57(a)(8) provide that the adjusted basis of the property is determined pursuant to Code section 1016 and the related regulations. See Treas. Reg. section 1.57-1(h)(3). Consequently, for minimum tax purposes, the adjusted basis of each property must be determined by taking into account all of the basis adjustments provided by Code section 1016 and the regulations thereunder.

B. Calculation of Adjusted Basis Under Section 1016.

The term "adjusted basis" is precisely defined in the Code and Regulations. (Pet. App. 11a). The adjusted basis of any property is its initial cost, adjusted as provided in Code section 1016. See Code sections 1011 and 1012, and Treas. Reg. section 1.1011-1. Pursuant to Treas. Reg. section 1.1016-2(a), the adjusted basis of any property includes "*the cost of improvements and betterments made to the property.*" Treas. Reg. section 1.1016-2(a) provides, in pertinent part, as follows:

The cost or other basis shall be properly adjusted for any expenditure. . . . or other item, properly chargeable to capital account, *including the cost of improvements and betterments made to the property.* (Emphasis added).

The Petitioner does not dispute that the tangibles at issue in this case are improvements and betterments to Taxpayers' mineral deposits. (Pet. App. 8a, A. 10, and Pet. Br. 11 and 23). Therefore, based on the clear and unambiguous language of Code section 57(a)(8), and the related regulations, the Claims Court and the Court of Appeals correctly held that, for purposes of computing depletion as a tax preference item, the adjusted basis of each of Taxpayers' oil and gas properties includes the costs of tangible improvements and betterments to those properties. (Pet. App. 11a). See *Patterson v. Shumate*, *supra*, at 2248; and *United States v. Ron Pair Enterprises, Inc.*, *supra*, at 241.

C. The Plain Language of Treas. Reg. Section 1.1016-2(a) Requires That All Improvements Are Included In The Calculation of Adjusted Basis.

Although Petitioner admits that tangibles are improvements and betterments to the mineral deposit, it attempts to avoid the inevitable result of such admission by asserting that they are "separate properties" subject to different "cost recovery methods." (Pet. Br. 10-11, 23-24). Petitioner cites no authority for this proposition, except the statutory provisions and case law relating to the calculation of the tax deductions for depletion and depreciation. Clearly there are separate provisions in the Code for calculating depletion and depreciation.⁸ However, the fallacy of Petitioner's analysis is that this case does not involve the calculation of the depletion deduction, *per se*. This case involves the determination of *how much* of the depletion deduction constitutes a tax preference item and is, therefore, subject to the minimum tax. (Pet. App. 9a).

The formula provided in Code section 57(a)(8) requires taxpayers to make this determination by reference to the adjusted basis of the property, computed in accordance with the rules of Code section 1016 and the related Regulations. Contrary to Petitioner's argument, nothing in the

⁸The depreciation deduction, however, is a factor in determining the allowable depletion deduction. Code section 613(a) limits the depletion deduction to 50% of the taxable income from the property. Taxable income is the gross income from the property, less all allowable deductions attributable to producing the mineral deposit. Depreciation of the improvements to the mineral deposit, is an allowable deduction in computing taxable income. Treas. Reg. section 1.613-5(a). Thus, the depreciation deduction for tangibles reduces the taxable income from the property and thereby reduces the depletion allowance.

language of either Code section 1016 or Treas. Reg. section 1.1016-2(a) limits the type of improvements which may be included in adjusted basis by reference to the cost recovery method used for calculating the tax deductions associated with those improvements.⁹ Treas. Reg. section 1.1016-2(a) clearly contemplates a basis increase for the cost of *all* improvements or betterments to a mineral deposit, because it specifies that the adjusted basis *shall include* those costs. The use of the word "including" is a term of enlargement, not of limitation. See *Telecommunications, Inc. v. Comm'r.*, 95 TC 495, 514 (1990), and 2A *Sutherland's Statutory Construction*, §47.07, (5th Ed. 1992).

Code section 1016 does not predicate a basis adjustment on whether an expenditure is chargeable to a particular capital account. Rather, the phrase "properly chargeable to capital account" operates to distinguish capital expenditures made with respect to property, which increase adjusted basis, from currently deductible expenses which do not. An expenditure to repair property is normally deductible for tax purposes. Therefore, it is not properly chargeable to capital account and it cannot increase the property's basis under Code section 1016.¹⁰

⁹In Technical Advice Memorandum ("TAM") 8314011 (December 22, 1982), the IRS ruled that section 616 unamortized deferred mine development costs were includible in adjusted basis for minimum tax purposes, *even though they were not subject to depletion*. TAMs are cited herein as being representative of the IRS' administrative position. See *Rowan Companies, Inc. v. United States*, 452 U.S. 247, 261 (1981), n.17; *Hanover Bank v. Comm'r.*, 369 U.S. 672, 686-687 (1982).

¹⁰See the second sentence of Treas. Reg. section 1.1016-2(a), which provides that "No adjustment shall be made in respect of any item which, under any applicable provision of law or regulation, is treated as an item not properly chargeable to capital account but is allowable as a deduction in computing net or taxable income for the taxable year."

But, if the deduction is denied because the outlay adds to the value of the property or adapts it to a new purpose, the expenditure is properly chargeable to capital account and a basis increase is warranted.¹¹

The tangible improvements at issue in this case are exactly the type of capital expenditures which section 1016 contemplates will be added to adjusted basis.¹² (Pet. App. 15a). They are expenditures made with respect to a mineral deposit which are not currently deductible for tax purposes.¹³ They are not separate

¹¹Treas. Reg. section 1.1016-2(a). The term "capital account" refers to fixed assets as a class. It is used in such expressions as "additions during the year to capital account." See Kohler, *A Dictionary for Accountants* (8th Ed. 1976, p. 80). *United States of America v. The Albertson Company*, 219 F.2d 920, 922 (1st Cir. 1955) ("certain expenditures are chargeable to capital account and, therefore, must be capitalized"); *Ralph E. Purvis*, 65 T.C. 1165, 1168 (1976) ("chargeable to capital account is used in the customary accounting sense of capitalization").

¹²See H.R. Rep. No. 179, 68th Cong., 1st Sess. (1924), reprinted in 1939-1 (Part 2) C.B. 241, 250: "Under this provision [the predecessor of section 1016] capital charges, such as improvements and betterments . . . are to be added to the cost of the property in determining gain or loss from its subsequent sale." Petitioner's example at Pet. Br. 24 at n.16 is misleading. It presumes that the parking garage is not an improvement to the shopping center, i.e., not a capital addition, because it postulates that the garage is a separate property adjacent to the shopping center. If the parking garage were an addition to and built as part of the shopping center, it would be an improvement to that property and included in adjusted basis. See note 15, *infra*.

¹³The general rule under section 263 of the Code is that a taxpayer cannot deduct "any amounts paid for . . . permanent improvements or betterments made to increase the value of any property". Capital expenditures refer to amounts paid or incurred (1) to add to the value or substantially prolong the useful life of property owned by the taxpayer; or (2) to adapt property to a new or different use. Amounts paid or incurred for incidental repairs and maintenance of property are not capital expenditures. See Treas. Reg. sections 1.263(a)-1(a) and (b).

properties, as Petitioner maintains, because they are additions to and become part of the property improved. Tangibles are connected to the mineral deposit in order to enhance its value and its utility by developing and producing the mineral.¹⁴

The regulations do, as Petitioner points out, provide for the maintenance of a variety of accounts with respect to a mineral property (although these accounts are not referred to as capital accounts in the Regulations, as Petitioner maintains). See Treas. Reg. sections 1.611-2(b), 1.611-5(c); 1.167(a)-7. These accounts are used to keep track of and to calculate the tax deductions for the depletion and depreciation associated with a mineral property. They do not provide rules for calculating adjusted basis; nor do they provide a special rule which excludes certain kinds of improvements from the calculation.

Petitioner's reliance on the existence of these accounts is misconceived. The Code and the Regulations include improvements in adjusted basis because they are capital additions to the property improved; not because they are charged to any particular account or subject to any particular cost recovery method.¹⁵

¹⁴"Improvement": A valuable addition made to property or an amelioration in its condition, amounting to more than mere repairs . . . intended to enhance its value, utility or to adapt it for new or further purposes." *Black's Law Dictionary*, 5th Ed., p. 682. "Betterment": An improvement of an estate (as by the addition of new buildings) that makes it better and more valuable than mere repairing would; an expenditure that adds greater worth (as extended life or increased capacity) to a fixed asset. *Webster's Third New International Dictionary*, p. 209.

¹⁵If a taxpayer installs a new furnace in an old building he or she owns, the cost of the furnace would be kept in a separate account from the building because the cost recovery period and

[footnote continued]

D. Treas. Reg. Sections 1.612-1(a) and (b)(1) Confirm That Tangible Improvements Are Included in Adjusted Basis For Purposes of Code Section 57(a)(8).

The lower courts recognized that Petitioner's position, in this case is contrary to the Treasury Department's own Regulations. (Pet. App. 20 and 21a). Since January 20, 1960, Treas. Reg. sections 1.612-1(a) and (b)(1) have prescribed the method for determining cost depletion. Those Regulations provide that the adjusted basis for determining cost depletion is calculated under the general rules of Code section 1016 and the related Regulations, with only one exception. This exception creates a *special rule* which specifically excludes amounts recoverable through depreciation from adjusted basis, solely for purposes of calculating cost depletion. Treas. Reg. sections 1.612-1(a) and (b)(1) provide in pertinent part as follows:

(a) *In general.* The basis upon which the deduction for cost depletion under section 611 is to be allowed in respect of any mineral or timber property is the adjusted basis provided in section 1011 for the purpose of determining gain upon the sale or other disposition of such property *except as provided in paragraph (b) of this section.* The adjusted basis of such property is the cost or other basis determined under section 1012, relating to the basis of property, *adjusted as provided in section 1016, relating to adjustments to basis, and the Regulations under such sections . . .* (Emphasis added).

depreciation method for the furnace would be different than for the building. The furnace could be removed from the building and, in that sense, could be considered a separate property. Nonetheless, the furnace is an improvement made to the building, and it is included in the adjusted basis of the building. Treas. Reg. section 1.1016-2(a).

(b) *Special rules.* (1) The basis for cost depletion of mineral or timber property does not include:

(i) *Amounts recoverable through depreciation deductions*, through deferred expenses, and through deductions other than depletion, and . . . (Emphasis added).

The plain language of these regulations illustrates that Petitioner's argument mistakenly equates the calculation of adjusted basis under Treas. Reg. section 1.57-1(h)(3) with the calculation of depletable costs under Treas. Reg. sections 1.612-1(a) and (b)(1). It is the calculation of adjusted basis under section 57(a)(8) which is at issue in this case. The "special rule" provided by Treas. Regs. section 1.612-1(a) and (b)(1) is not found in the section 57(a)(8) regulations. To the contrary, Treas. Reg. section 1.57-1(h)(3) mandates the ordinary section 1016 procedure by stating: "for the determination of the adjusted property at the end of the year, *see* Code section 1016 and the Regulations thereunder."

These Regulations negate all of Petitioner's attempts to create a theoretical justification for its deviation from the plain language and ordinary meaning of section 57(a)(8), and the related Regulations by reference to such concepts as the definition of property, a mineral deposit vs. mineral enterprise distinction, or a separate capital account rule. By specifying that for section 612 cost depletion purposes, a special rule applies which excludes tangibles from the calculation of adjusted basis, Treas. Reg. section 1.612-1 confirms that, absent a special rule, the adjusted basis of a mineral deposit would include depreciable improvements.¹⁶ (Pet. App. 22a).

¹⁶The National Office of the IRS has also confirmed that a special rule must be specifically provided for before the general
[footnote continued]

E. The Definition Of "Property" Under Code Section 614 Does Not Exclude Depreciable Improvements From Adjusted Basis.

The property whose adjusted basis must be determined, for purposes of section 57(a)(8), is defined by section 614 as each *separate interest* owned by the taxpayer in each mineral deposit.¹⁷ Section 614 also provides extensive rules for determining when a taxpayer's separate interests in a mineral deposit can be combined into a single property.¹⁸ The determination of whether a taxpayer's separate interests are a single property or separate properties is important for a variety of purposes under the Code.¹⁹

basis calculation rule in section 1016 will be ignored for minimum tax purposes: "the term 'adjusted basis' has the same meaning, whether used in section 57(a)(8), section 612, or elsewhere in the Code, except where the term is *specifically defined differently*." (Emphasis added). TAM 8314011 (December 22, 1982).

¹⁷ The term "interest" means an economic interest in a mineral deposit, and includes working or operating interests, royalties, overriding royalties, net profits interests and certain production payments. Treas. Reg. section 1.614-1(a)(2). There is no dispute that Taxpayers own an economic interest in their mineral deposits. See the Joint Appendix filed with the Court of Appeals for the Federal Circuit, p. 9. Each economic interest in a mineral deposit consists of different rights to the mineral production and different burdens with respect to the costs of the development and operation of the mineral deposit. For example, a royalty interest is not burdened with the cost of development, while a working interest must pay for the cost of the tangible improvements necessary for the development and operation of the property. See C.W. Russell, *Income Taxation of Natural Resources*, 202-206 (1991).

¹⁸ Code sections 614(a), (b)(1), and (b)(2), 614(e) and Treas. Reg. section 1.614-8(a)(1). The single property resulting from a combination of separate interests or each separate property, if the interests are not combined, is treated as *the property* for all purposes under the income tax provisions of the Code.

¹⁹ For example, depletion must be calculated separately for each section 614 property. See Code sections 612 and 613.

[footnote continued]

Code section 614 does not, however, contain any rules for determining what adjustments to the cost of that property are appropriate when calculating adjusted basis for purposes of Code section 57(a)(8). (Pet. App. 14a). Pursuant to Treas. Reg. section 1.57-1(h)(3), that subject is covered by section 1016 and, as described above, Treas. Reg. section 1.1016-2(a) directs taxpayers to increase the adjusted basis of property by the cost of improvements and betterments made to the property. The definition of property in section 614 is, therefore, only the starting point for the calculation of adjusted basis. Nothing in the language of Code section 614, or the related Regulations, directs taxpayers to exclude tangible improvements from the calculation of adjusted basis.²⁰

The Petitioner's proposed interpretation of Code section 57(a)(8) "blurs the distinction between the property and the improvements to the property."²¹ (Pet. App.

Gain or loss on sale is also computed separately for each property. See Code section 1011 and 1016. As indicated by Treas. Reg. section 1.57-1(h)(1), section 57(a)(8)'s reference to the section 614 property requires a separate calculation of depletion as a tax preference item for each separate property.

²⁰ Contrary to Petitioner's assertions, the section 614 Regulations illustrate that tangible improvements are part of the section 614 property. Treas. Reg. section 1.614-8(a)(1) states that the combination of separate interests does not preclude the use of more than one depreciation account for "improvements made with respect to the separate interests combined . . .". This Regulation illustrates that the accounts used for tax deduction purposes have nothing to do with whether an expenditure is an improvement to the section 614 property. See, also, Treas. Reg. sections 1.614-2(a)(2) and -3(a)(1) which contain similar language.

²¹ Petitioner's reliance on the definition of a mineral enterprise at Treas. Reg. section 1.611-1(d)(3) is misconceived. This definition supports Taxpayers' position because it provides further evidence that Treasury has always treated tangibles as improve-

[footnote continued]

14a). There is no requirement in either section 614, section 57(a)(8), or section 1016, that an expenditure be a mineral deposit, *per se*, in order to be included in adjusted basis. All that is required, pursuant to Treas. Reg. section 1.1016-2(a), is that the expenditure constitutes an improvement to the property. Furthermore, Petitioner's argument is inconsistent with the undisputed way in which Petitioner treats intangible improvements.²² Intangible improvements, such as road making, clearing ground,

ments to the mineral deposit. This definition is used to assist in identifying depletable and depreciable costs when an operating mineral property is acquired as a unit. See Treas. Reg. section 1.611-1(d)(4). Its use is for Part I - Deductions, Subchapter I (Natural Resources) of the Code and not for any other part of the Code. See Treas. Reg. section 1.611-1(d). The mineral enterprise definition does not address the computation of adjusted basis under section 1016; nor does it override the rule that that adjusted basis of property is its initial cost, plus the cost of improvements. Thus, the mineral enterprise concept is merely a red herring designed to distract this Court's attention from the plain language of Code section 1016 and the related Regulations.

²²"Intangible improvements" or "intangibles" are expenditures for wages, fuel, repairs, hauling, supplies, etc., incident to and necessary for the drilling of wells and the preparation of wells for the production of oil and gas. Intangible improvements may, at the taxpayer's option, be chargeable to capital or to expense. Treas. Reg. section 1.612-4(a). If taxpayers elect to capitalize intangibles, their cost is recoverable either through depletion or depreciation. See Treas. Reg. sections 1.612-4(b)(1) and (2). Capitalized intangibles associated with physical property (*i.e.*, wages, fuel, repairs, hauling, supplies, etc. used in the installation of casing and equipment, and in the construction on the property of derricks and other physical structures) are returnable through depreciation. Treas. Reg. section 1.612-4(b)(2). Capitalized intangibles not represented by physical property (including expenditures for clearing ground, draining, road making, surveying, geological work, excavation, grading, and the drilling, shooting, and cleaning of wells) are returnable through depletion. Treas. Reg. section 1.612-4(b)(1).

excavating and grading, are no more mineral deposits than are tangible improvements, such as casing, pumps, pipes, and well equipment. Yet Petitioner argues that intangible improvements are included in adjusted basis, while tangible improvements are not included. The lower courts correctly found no basis for this distinction, for purposes of Code section 57(a)(8). (Pet. App. 14a and 15a). Both tangible and intangible improvements are included in adjusted basis, in accordance with Treas. Reg. section 1.1016-2(a), because they are both improvements to the property.

II.

THE LOWER COURTS' DECISIONS CORRECTLY INTERPRETED CODE SECTION 57(a)(8).

When Congress established the minimum tax, it clearly intended to reduce the tax benefit derived from the depletion deduction. But, in drafting section 57(a)(8), Congress had to balance its desire to reduce that tax benefit with its long-standing policy of encouraging the development of the Nation's natural resources.²³ A significant portion of this Nation's energy policy is found in the Internal Revenue Code.²⁴ Thus, it is probable or at least conceivable, as the lower courts recognized, that Congress sought to implement its plan to reduce the tax benefit provided by the depletion deduction, in a manner

²³The percentage depletion deduction is a tax incentive, designed to subsidize the development of our Nation's natural resources and to encourage taxpayers to engage in that line of business. See *Comm'r. v. Engle*, 464 U.S. 206, 208 (1984), and *U.S. v. Swank*, 451 U.S. 571, 576 (1981).

²⁴*Supra*, n.6.

that would not undermine its effectiveness as an incentive for the development of mineral deposits.²⁵

Including tangibles in the formula for determining how much depletion is a tax preference item represents a reasonable compromise between these competing policy goals. It ameliorates the hardships created by Code sections 56 and 57, by applying the minimum tax, only after taxpayers have recovered their full investment in the property, including the cost of the tangible improvements which are necessary to develop and produce the mineral deposit.²⁶ Without the addition of tangible improvements to the property, there can be no production and, therefore, no depletion deduction to give rise to the minimum tax.²⁷ Affirming this decision does not allow

²⁵ The importance of percentage depletion as an incentive for the development of the domestic oil and gas industry is illustrated by the fact that one of the Administration's proposals to counteract our growing dependence on foreign oil, is to delete percentage depletion from the list of tax preference items in section 57. See Letter from President George Bush to Thomas S. Foley, Speaker of the House of Representatives, dated April 20, 1992, in support of H.R. 776. This revision would only affect small, independent oil and gas producers since large producers cannot claim percentage depletion. See Code Section 613A.

²⁶ If anything, the minimum tax has reduced the tax incentive provided by the depletion deduction too much for independent oil and gas producers. Congress is currently considering legislation which, for the time being, would delete percentage depletion from the list of tax preference items. The Committee Reports to this legislation indicate Congress' belief that the effectiveness of the oil and gas incentives for domestic drilling and production have been reduced too much. See *Comprehensive National Energy Act* (H.R. 776), H.R. Rept. 102-474, 102nd Cong. 2d Session 43-44, and S.R. Rept. 102-95, 19-21. If this legislation becomes law, the issue raised by this case will become moot for independent oil and gas producers, such as Taxpayers, through 1997.

²⁷ Code section 613(a) only permits a deduction for depletion if there is gross income from the property.

taxpayers to escape the impact of the minimum tax, as Petitioner's hyperbole suggests. Taxpayers did, in fact, report and pay a minimum tax for percentage depletion of \$29,812 for 1981 and \$26,736 for 1982, using the method approved by the lower courts. (See A.7).

Nothing in the legislative history to section 57(a)(8) indicates that Congress intended to deviate from the general basis rules under Treas. Reg. section 1.1016-2(a), or that it desired to follow the long standing special basis rule of Treas. Reg. sections 1.612-1(a) and (b)(1).²⁸ When the Treasury Department drafted the proposed regulations under Code section 57(a)(8), shortly after that section's enactment, it apparently did not perceive the legislative intent to be that tangibles should be excluded from the calculation of adjusted basis.²⁹ Otherwise,

²⁸ As the Claims Court found, "there are brief statements that arguably benefit each side, but nothing definitive." Pet. App. 15a, n.10. Moreover, Petitioner has previously admitted that the legislative history was "not all that helpful." Pet. App. 15a, n.10. The 1986 Committee Report, cited by Petitioner, actually supports Taxpayers because the reference to the adjusted basis of the depletable property confirms that the Code section 1016 meaning of that term should apply. The 1969 Committee Report uses the term "property", as defined in section 614, not the term depletable property. Furthermore, the term depletable property no more defines what basis adjustments are appropriate under section 1016 than does the term section 614 property. It is the Treasury Regulations under Code section 1016 which describe the proper calculation for adjusted basis. Moreover, although this history supports Taxpayers, they acknowledge that the views of a 1986 Congress, as to the construction of a statute adopted many years before by a 1969 Congress, have very little, if any, relevance and, this Court has determined, are not part of the legislative history. *Weinberger v. Rossi*, 456 U.S. 25, 35 (1982); *Andrus v. Shell Oil Co.*, 446 U.S. 657, 666, n.8 (1980); *Oscar Mayer & Co. v. Evans*, 441 U.S. 750, 758 (1979).

²⁹ See Prop. Reg. section 1.57-1(h)(3), originally proposed on December 30, 1970, 35 Fed. Reg. 19, 768 (Dec. 30, 1970).

[footnote continued]

Treasury would have drafted Treas. Reg. section 1.57-1(h)(3) to incorporate the special rule of Treas. Reg. sections 1.612-1(a) and (b)(1), excluding tangibles from adjusted basis.³⁰ The clarity of Treas. Reg. section 1.57-1(h)(3) makes it obvious as to what the drafters of those regulations understood to be the Congressional intent.³¹ See *Patterson v. Shumate*, *supra*, *Toibb v. Radloff*, 111 S.Ct. 2197 (1992), *United States v. Ron Pair Enterprises*, *supra*, 241, *Consumer Product Safety Comm'n. v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1990).

III.

THE TREASURY DEPARTMENT IS BOUND TO FOLLOW ITS OWN REGULATIONS.

Taxpayers navigated the maze of Regulations under Code sections 57, 614 and 1016 when they prepared their federal income tax returns and they calculated their minimum tax in accordance with the plain meaning of those rules. They followed the clear language of Treas. Reg. section 1.1016-2(a), which directs that the cost of improvements and betterments made to the property be included in the calculation of adjusted basis. Petitioner

The final regulations were issued without any change in this language.

³⁰ Treas. Reg. sections 1.612-1(a) and (b) had been outstanding for approximately ten years at the time Treas. Reg. section 1.57-1(h)(3) was originally proposed. See T.D. 6446, 1960-1 CB 208.

³¹ A substantially contemporaneous and long standing construction by the Treasury Regulations is presumed to reflect Congressional intent. *National Muffler Dealers Association, Inc. v. United States*, 440 U.S. 472, 477, 489 (1979); *Chevron, U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 844 (1984).

is now telling Taxpayers that what the Treasury Department really intended to do was to draft Treas. Reg. section 1.57-1(h)(3) so that it contained the *special rule* found in Treas. Reg. sections 1.612-1(a) and (b)(1).³² The Claims Court and the Court of Appeals properly rejected the Petitioner's argument, stating:

"A taxpayer is entitled to . . . consistency in definition. Where Congress and the Department of Treasury choose to employ a technical term such as 'adjusted basis,' a taxpayer must be given reasonable notice when the term is intended to have other than its ordinary meaning in the Code. Herein, no such notice was supplied, and plaintiffs [Taxpayers] calculated their taxes according to the ordinary meaning of the terms in the controlling statutes and regulations. Taxpayers can be expected to do no more. Taxpayers are obliged to do no more." (Pet. App. 22a).

This is not the first case where the Treasury Department has attempted to ignore the plain meaning of its own regulations, and it may not be the last. But the courts have consistently rejected those attempts, because Treasury Regulations are as binding on the Treasury Department as they are on taxpayers.³³ The complexity

³² "This phenomenon calls into question whether our legal culture has so far departed from attention to text or is so lacking in agreed-upon methodology for creating and interpreting text, that it no longer makes sense to talk of 'a government of laws, not of men'." Justice Scalia's concurring opinion in *Patterson v. Shumate*, 112 S.Ct. at 2250-51.

³³ *Helvering v. R.J. Reynolds Tobacco Co.*, 306 U.S. 110 (1939); *McCord v. Granger*, 201 F.2d 103 (3d Cir. 1952); *Mutual Savings Life Insurance Co. v. United States*, 488 F.2d 1142, 1145 (5th Cir. 1974); *Pacific National Bank of Seattle v. Comm'r.*, 91 F.2d 103, 105 (9th Cir. 1937); *Lansons, Inc. v. Comm'r.*, 622

[footnote continued]

of our self-assessment tax law requires that taxpayers be entitled to rely on the plain meaning of the Treasury Department's Regulations. Fairness requires that Treasury Regulations not be subject to different interpretations in accordance with Treasury's varying budgetary needs.³⁴ The tax law should be fairly applied, based on the plain meaning of the Code and the Regulations, not the revenue impact.

If the Treasury Department is now dissatisfied with its clear and unambiguous Regulations, or believes that they provide taxpayers with an unintended benefit, it should seek revisions by Congress, or should attempt to revise its regulations. However, when the Treasury Department has not taken steps to amend the regulations, its failure to use its broad power in this area does not justify judicial interference in what is essentially a legislative and administrative matter.³⁵

F.2d 774, 776 (5th Cir. 1980); *Brafman v. United States*, 384 F.2d 863, 866 (5th Cir. 1967); *Tipton and Kalmbach, Inc. v. United States*, 480 F.2d 1118, 1121 (10th Cir. 1973).

³⁴No foundation for Petitioner's revenue estimates is found in the record.

³⁵*Woods Investment Co. v. Comm'r.*, 85 T.C. 274, 282 (1985); *Henry C. Beck Builders, Inc. v. Comm'r.*, 41 T.C. 616, 628 (1964); *Transco Exploration Co. v. Comm'r.*, 95 T.C. 373, 384 (1990), *aff'd*, 949 F.2d 837 (5th Cir. 1992); *T. Jack Foster v. Comm'r.*, 25 T.C.M. (CCH) 1390, 1417 (1966); *Idaho First National Bank v. Comm'r.*, 95 T.C. 185, 193 (1990); *Honeywell, Inc. v. Comm'r.*, 87 T.C. 624, 635 (1986).

CONCLUSION

The Court of Appeals' decision should be affirmed.

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